Research and Strategies on the Risks of Foreign Direct Investment in Different Countries

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Abstract: As a common business behavior of multinational enterprises and governments, foreign direct investment has brought huge benefits and risks. At the national level, this article shows four main reasons for the different risks of foreign direct investment in different countries through political environment, economic environment, government behavior and democracy institution. In order to make foreign direct investment better. Countries and international organizations could avoid or reduce risks as much as possible through international assistance, property rights protection, improving the regulatory system of laws and regulations and using international accounting standards.

1. Introduction

With the development of political and economic globalization, foreign direct investment (FDI) has become a common business activity. FDI is defined as an investment in which investors have control over enterprises in other countries (Olga, 2020). FDI has brought immense benefits to the multinational companies, promoting the economic development of the host country. At the same time, however, it brings some unpredictable risks. In recent years, many economists have made extensive research on the risk of FDI. Due to the different environment of the host country, multinational companies will face different kinds and different degrees of risks when making investment. Multinational companies may take economic risks in investment in developed countries such as the United States due to economic crisis or trade barriers, while they may face political risks due to political turmoil when investing in African or Middle East countries (Busse and Hefeker, 2007). Therefore, the main purpose of this article is to analyze the specific reasons why FDI has distinct risks in different countries, and how to avoid or reduce risks as much as possible.

2. The Reasons for Different Risks of Fdi

2.1 The Political Environment

It is possible that the political environment of the host country is the main reason for the different FDI risks. The level of FDI inflow is highly related to the political environment. Among developing countries, countries with lower political risk can attract more foreign capital inflow (Jun & Singh, 1996). Busse and Carsten (2007) conducted an extensive study on 12 political risk indicators such as national government and social economy by using econometric, and finally found that the stability of the government in host country, civil strife, international relations, legal integrity and stability, ethnic relations, and the quality of government officials are the determinants of investment from multinational companies in them. Busse (2007) states that a stable government provides an environment and system guarantee for investors and reduces the uncertainty factors due to civil strife, war, corruption and international disputes. Busse (2007) notes that the more unified ethnic relations have fewer language or nationality conflicts, which makes it easier for foreign investors to invest in the whole country. At the same time, sound and stable laws, efficient government and high-quality officials are closely related to the strength of the government, which provides a good guarantee for the operation of foreign direct investment (Busse and Carsten, 2007).

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2.2 The Economic Environment

In addition to the political environment, the economic environment of the host country also has an impact on investment risk. Market size, the level of international trade, macroeconomic policy and labor cost are the four main aspects of multinational companies' consideration of economic environment. Pravin (2012) states that Market size has been widely considered as an important determinant of FDI in economy, which is generally represented by gross national product (GDP). Higher GDP shows stronger purchasing power, from which enterprises can obtain more investment returns and profits (Pravin Jadhav, 2012). According to Busse (2007), countries with a higher degree of foreign trade have relatively open trade policies and fewer restrictions on economic and market. A good macroeconomic policy of host country provides a better economic environment for multinational corporations, it has less fiscal deficit and lower inflation rate, and reduces the risk premium of investment and transaction costs (Busse and Hefeker, 2007). Pravin (2012) points out that multinational companies tend to invest in countries with lower wages, which reflects lower production costs. Multinationals may be more inclined to invest in such countries. It may be contended that FDI faces low risk in economic factors when the economic environment of the host country meets these four points.

2.3 The Government Behavior

To some extent, the government behavior of host country has an effect on FDI. Busse (2007) states that the risk of government behavior mainly refers to the negative impact of government actions on the investment activities of multinational corporations, including breach of contract, changing of law, government expropriation. All of these directly or indirectly violate the investment contract. More than 60% of multinational corporations investing in developing countries have experienced frequent changes in terms of affecting their business, due to unpredictable government default (Busse and Carsten, 2007). Busse (2007) investigated the cases of government default in Venezuela. In early 1990, Venezuela signed oil industry contracts with 22 foreign oil companies. However, due to the government's change of law, it forced the state-owned company PDVSA to increase its ownership of oil projects, as well as to increase the enterprise income tax and the royalties of special envoys of foreign oil companies. It may be contended that this kind of risks are more unpredictable than political and economic risks. When the government violates the investment contract, it might have a greater impact on FDI, because multinational companies could not make adequate preparation for risk management before investment, as in dealing with political or economic risks.

2.4 Democracy Institution

The impact of democracy on FDI is still controversial. Some scholars believe that a high degree of democratic governance will contribute to more FDI inflows. Investors will have better security when investing in countries with mature democratic systems. This is because the independent judiciary and electoral policies in democratic countries are relatively perfect, which will provide more protection for the inflow of property rather than being plundered by dictators (Olson 1993). However, more scholars support the opposite view. National political leaders in autocratic countries may collude with investors. Despite the threat of public opinion, dictators will protect foreign capital by raising wages, reducing taxes and strengthening the protection of labors (O'Donnell, 1978; O’Donnell, 1988). In countries with well democratic governance, officials and governments will give priority to providing institutionalized guarantee for indigenous enterprises, while the oligopoly position that multinational corporations want to achieve will be weakened by democratic policies, and the financial incentives provided to multinational enterprises will be further limited (Quan and Adam, 2003).

3. Strategies to Avoid or Reduce Fdi Risk

The risk of investment in the host country is inevitable. How to reduce the loss caused by the risk is one of the most concerned topics of multinational corporations and many other countries. Reducing the risk of FDI can make multinational companies gain more profits and promote the economic development of host countries. Both multinational companies and host countries should come up with corresponding measures to reduce investment risk.

3.1 International Aid

International aid may be an effective way to reduce the risk of FDI. Elizabeth (2009) points out that the investment funds of multinational corporations to some poor countries, especially those in sub-Saharan Africa, are likely to face the risk of goverment behavior results from government expropriation, violation of contracts, change of laws and other government actions of host countries. The multilateral aid provided by many international development agencies effectively prevente government expropriation and reduce the risk faced by investors (Elizabeth, Yi & Boaz, 2009). Therefore, Elizabeth, Yi and Boaz (2009) analyzed the poor countries in South Africa, trying to simulate the correlation between international aid and FDI. The calculation data shows that international aid can effectively reduce the risk of FDI expropriation, but it cannot be completely offset due to the lack of enforcement and supervision of laws and regulations. It is might be suggested that the improvement of laws and regulations is another effective way to reduce the risk of FDI.

3.2 Property Rights Protection

Strengthening the protection of property rights may be the property protection provided to multinational corporations from the perspective of the host country. Through empirical analysis, Quan and Adam (2003) found that the property rights protection related to democracy, which is composed of three indicators: confiscation and expropriation risk, government refusal of contract risk and rule of law, has a positive and important impact on FDI inflows. The superior property right policy could strengthen the guarantee of enterprise contract execution to a certain extent, reduce the risk of foreign investors, and enhance the attraction of foreign investment. On the contrary, countries with poor property rights protection may have to take more measures to encourage multinational enterprises to invest through preferential taxes, land purchase, natural resources purchase (Quan and Adam, 2003). Therefore, the gradual improvement of property rights policy could reduce the cost of national resources in order to attract foreign investment, and there is no need to restructure the relationship between the state and society on a large scale.

3.3 Implementation and Supervision of Laws and Regulations

Implementation and supervision of laws and regulations are the effective guarantee for FDI. Elizabeth (2009) suggests that sounds laws of the host country, specify punishment measures in the contract and the establishment of transnational institutions could reduce the risk of government behavior of FDI and improve the effectiveness of international aid. Firstly, the host country should improve its own laws on receiving investment or assistance, reduce the change of relevant laws or contracts, and set up relevant institutions for implementation and supervision, so as to reduce its own risks (Elizabeth, Yi & Boaz, 2009). Secondly, Elizabeth (2009) points out that clear punishment measures for breach of contract should be established in the contract, whether it is a multinational company or a host country, which should include all possible breach situations, and ensure the validity of this clause, so as to ensure that both sides could still reply to the contract under uncertain factors such as change of law or withdrawal of capital. In addition, the joint international organization should be established in the world to supervise the implementation of FDI. This organization should have the power higher than each country to ensure that it could enforce the obligations related to the investment contract, and could implement the corresponding punishment measures fairly without considering the state status of the host country in case of breach of contract (Elizabeth, Yi & Boaz, 2009).

3.4 Same Accounting Policies

The implementation of the same accounting standards in different countries, such as international financial reporting standards (IFRS), could greatly reduce the risk of FDI. Through statistics and analysis of Sweden's FDI to 73 countries, it is proved that whether the host country can attract foreign investment and obtain profits depends on its level of adoption of IFRS (Olga, 2020; Mattias, et al., 2013). Under the same accounting standards, the host countries have the same data variables and calculation methods to explain the profitability of FDI, which helps to enhance the comparative ability of different companies in different countries (Mattias, et al., 2013). Mattias (2013) states that the improvement of comparability reduces the uncertainty of investors' future earnings and avoids the investment costs arising from transactions under different accounting standards. It could be suggested that the reduction of policy and computational risk caused by different accounting standards could attract more foreign investment.

4. Conclusion

The above analysis attempts to show the reasons for different investment risks in different countries under the four levels of political environment, international trade level, government behavior and democratic governance. The political environment seems to be the most important factor. There are many uncertain factors such as political turmoil in the host countries of some developing countries, which increase the investment risk. The level of a country's foreign trade also affects investors' decision-making. Government behavior is the most unpredictable risk in FDI. The degree of democracy in the host country would also affect the investment intention of transnational corporations. This article has argued that investors should first adopt international aid rather than direct investment because the investment funds are expropriated by the government of the host country. It will effectively avoid the possibility of government expropriation and reduce the risk of FDI. In addition, the host country should strengthen the protection of property rights, improve relevant laws and regulations, multinational companies and the host country should determine a clear contract to ensure the smooth flow of foreign investment. Finally, developing countries could use international financial report standards to enhance the attractiveness of external investment.

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